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RUCPDO/DEPT OF COMMERCE WASHDC
RUEHKO/AMEMBASSY TOKYO 1226
RUEHBJ/AMEMBASSY BEIJING 4546
RUEHBY/AMEMBASSY CANBERRA 1678
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UNCLAS SECTION 01 OF 03 JAKARTA 003296

SIPDIS

SENSITIVE
SIPDIS

DEPT FOR EAP/MTS, EAP/RSP AND EB/IFD/OMA
TREASURY FOR IA-BAUKOL, OTA-MCDONALD
SINGAPORE FOR TREASURY-BAKER
COMMERCE FOR 4430-BERLINGUETTE
DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO FOR TCURRAN
DEPARTMENT PASS EXIM BANK

E.O. 12598: N/A
TAGS: [EFIN](#) [EINV](#) [ECON](#) [PGOV](#) [ID](#)
SUBJECT: INDONESIA - OBSTACLES AND PROGRESS IN CAPITAL MARKET
DEVELOPMENT

REF: A) Jakarta 978 (Insurance Sector);
B) Jakarta 1128 (Monetary Policy Instruments);
C) Jakarta 3099 (Foreign Restrictions on SBI)

¶1. (SBU) Summary: Tax, legal and accounting issues are impeding the development of securities markets and products in Indonesia. Market participants and some regulators argue that the lack of hedging instruments and financing techniques is the key obstacle to securities market development. On the positive side, regulators are starting to research initiatives to improve the insurance industry, including addressing long-time insolvent firms. Civil service reform is also reducing opportunities for rent seeking, which may improve both regulation and corporate governance. Indonesian securities supervisors have requested help from the U.S. Securities and Exchange Commission (SEC) in improving disclosure and market surveillance (see para 15) and the SEC plans to respond to the request with a visit in early 2008. End Summary.

T-Bills and SBI

¶2. (U) Indonesia's banking sector suffers from chronic excess liquidity. BI issues Sertifikat Bank Indonesia -SBIs - as part of open market operations. BI uses SBI as sterilization and liquidity instruments with one- and three-month maturity. (See reftel B.) Due to the limited supply of alternative financial assets, overseas investors buy SBI, which reduces the effectiveness of BI's liquidity management activities. Despite Indonesia's progress in setting up a primary dealer's market and holding its first T-Bill auctions in 2007, the Ministry of Finance has not yet issued T-Bills with less than one-year maturity. The expansion of availability of short-term T-Bills would not only help market development by filling in the short end of the yield curve, but would also provide a new monetary policy instrument besides SBI.

¶3. (U) Currently, a 20% up-front tax hit on T-Bills appears to be a small - but not insurmountable -- disincentive for many investors and securities dealers. However, Bank Indonesia (BI) is refusing to pay withholding tax on T-Bills, and therefore will not purchase them for use as monetary instruments. One bond market expert noted that taxing a central bank on purchases of government bonds had virtually no precedent anywhere in the world.

14. (SBU) The availability of T-Bills is an important aspect of the debate on potentially limiting foreign ownership of SBIs (reftel C). Without other short-term, rupiah-denominated securities such as T-Bills, for foreign investors to switch into, limiting foreign ownership of SBIs could potentially be destabilizing to the currency markets. Official sources told us, however, that there are plenty of ways to "work around" such a regulation, should BI ever issue it. Most view such a move as unlikely and BI officials confirmed in meetings with the Embassy that it has no plans to restrict foreign ownership of SBIs or introduce capital controls in the near term. Nevertheless, many market participants continue to believe it would be in Indonesia's best interest to exclude non-resident investors from the SBI market. Should foreigners ever be excluded, the GOI could potentially reduce any adverse impact by issuing more T-Bills to capture this demand.

Hedging Instruments Needed, Especially Repo Market

15. (SBU) Deutsche Bank's Director for Fixed Income Trading, Francis Soetopo, argued that the main problem in the bond market now is the absence of hedging instruments. He argued that providing hedging instruments should be the top priority from a regulatory point of view.

16. (SBU) The most important hedging tool would be a properly functioning repo market. According to Citibank Country Economist Anton Gunawan, BI officials want to rely on the private sector to develop a repo market so that BI will not have to be the counterparty to every repo transaction, thus reducing its own risk. However, debt officials told us that the private sector's Master Repo Agreement drafted previously is not working due to accounting and tax problems. Reportedly, banks that engage in repo agreements

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are not able to effectively remove the liability from their balance sheet even when it has been sold to others. Furthermore, repo transactions are subject to transfer taxes, even if the assets revert back to their original owner at the end of the repo deal.

17. (SBU) JP Morgan Managing Director Rizal Prasetyo also argued that international financial institutions are required to limit counter-party risk associated with local Indonesian banks. This means that the lines of credit available in local bank-to-bank repo agreements would be very small. He argued, therefore, that Bank Indonesia will have to be the counterparty for the foreseeable future if they want to have a deep and liquid repo market. However, even if BI were to seek a direct role as counterparty in repo transactions, they are unlikely to warehouse the variety of inventory required or want to disburse and/or absorb large cash balances at the request of the dealer community.

Hope for Progress after Stock Exchange Merger

18. (SBU) BAPEPAM Chairman Fuad Rahmany believes that the merger of the Jakarta (JSX) and Surabaya Stock Exchanges (SSX) will set the stage for development of better derivatives markets, although there will be some rough patches during the transition period. The merged exchanges, legally effective on November 30, are now called the Indonesia Stock Exchange (Bursa Efek Indonesia or BEI). Previously the SSX, which specialized in bond trading, wanted to explore derivatives (futures, options, real-estate investment trusts) but the underlying asset was often traded on the larger, more liquid JSX. Trading related securities on different exchanges creates problems in coordinating market surveillance to guard against market manipulation. As soon as the merged entity is stable, one bond market official predicted that the MOF and BAPPEPAM would roll out bond futures early next year. The SSX was already in the advanced stages of developing a financial futures contract for government bonds.

Addressing Taxation of Securities

19. (SBU) Rahmany also mentioned that tax was the biggest hurdle in

terms of securitization products, such as asset-backed securities. In addition to tax, real estate investment trusts (REITs) and mortgage backed securities are also held up by the national land agency, BPN. Two new government regulations are needed to address land title issues, custodial titles, the structure of new products and their tax treatment.

¶10. (U) The government does seem to have recognized the myriad of tax problems holding back market development. In response, Dr. Anggito Abimanyu, Head of the Ministry of Finance Fiscal Policy Office said that the Ministry of Finance is drafting a new law in 2008 to address tax treatment of:

-- Financial securities (which he noted were not covered under income tax);

-- Sharia bonds and other sharia investment instruments;

-- Derivatives and asset-backed securities.

Diversifying and Shoring Up Domestic Bond purchasers

¶11. (SBU) Rahmany said plans also were being developed to encourage more domestic players to participate in bond markets. One market expert reported that most insurance and pension assets are invested in shorter-term bank deposits rather than longer-term assets such as government or corporate bonds. This is partly due to regulatory rules that count 12-month deposits, but not government bonds, as regulatory reserves.

¶12. (SBU) Most observers believe that the resulting asset-liability mismatch has been allowed to persist due to concern about the solvency of a few large firms and pension funds. Rahmany admitted that the insurance regulator had been weak, and the Ministry of

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Finance is now trying to compensate for past neglect. At the industry level, former Coordinating Minister for the Economy (2001-2004) and Indonesian Ambassador to the U.S. (1998-2001) Dorodjatun Kuntjoro Jakti agreed to chair a "Blue Ribbon Commission" on insurance reform, long requested by international insurers in Indonesia to examine ways to improve the laggard sector. Terms of reference for the Commission are being drafted and will be submitted to BAPEPAM-LK for comment in the coming weeks.

GOI Confirms It Will Bail Out Large Insurer

¶13. (SBU) More narrowly, Rahmany confided that the GOI was looking for ways to bail out bankrupt insurer Bumiputera 1912 (reftel A), which has around 6 million policy holders. Due to the size and sensitivity of the bailout, Rahmany asked for our discretion, noting that it will be a very sensitive issue, requiring a presentation to Parliament, with a request to spend public money on the bailout. Despite its government connections - historically many rural civil servants supplemented their wages by selling its policies for commissions -- Bumiputera is technically a mutually-owned life company, not a state-owned company. "Eventually, we will have to demutualize it," Rahmany said. As Bumiputera 1912 is also the only mutual life insurance company in Indonesia, that path will be challenging.

Some Progress on Reducing Rent Seeking

¶14. (U) Civil service reform is helping to reduce some incentives and opportunities for rent seeking by regulators and other government officials. First, under the leadership of Finance Minister Mulyani and BAPEPAM Chairman Fuad Rahmany, salaries have tripled for BAPEPAM employees and raised significantly for high level Ministry of Finance officials (particularly those in Echelon 1). Secondly, Ministry of Finance Head of Fiscal Policy Anggito Abimanyu - who also sits on the board of PT Telkom, Indonesia's state-owned telecom company -- reported that a new policy requires government employees to refuse salaries provided as members of

boards of directors or commissioners. The new policy applies to the Ministry of Finance, the Supreme Audit Board (BPK), and the Supreme Court this year and is planned for the armed forces, police and judges next year. According to the plan, all central government officials will have to refuse any additional corporate salaries by 2012.

SEC Assistance Sought

¶15. (U) Rahmany said that BAPEPAM is grateful for assistance from the U.S. Treasury, the U.S. Securities and Exchange Commission, as well as Australia's Securities and Investment Commission (ASIC). Rahmany requested that the SEC team he requested for a review of market enforcement tools, come as early as possible in 2008. Rahmany would also like to see a review of the disclosure rules for listed companies. "There is a lot of misbehavior in our markets," Rahmany acknowledged. He seeks SEC assistance with two major items: the enforcement process including the Attorney General's Office (AGO) and techniques and analysis to review suspected cases of market manipulation. State, Treasury, IMF, SEC, and the Australia's Technical Assistance Management Facility for Economic Governance (TAMF) have been coordinating on assistance to BAPEPAM.

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